



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	<b>12/02/02</b>	Bill No:	<b>SB 17</b>
Tax:	<b>Property</b>	Author:	<b>Escutia</b>
Board Position:		Related Bills:	<b>SB 3X (2003)</b> <b>SB 1662 (2002)</b> <b>AB 1013 (2001)</b> <b>AB 2288 (2000)</b> <b>SB 82 (1991)</b> <b>Proposition 167 (1992)</b>

### BILL SUMMARY

This bill would state legislative intent to enact a program to redefine those circumstances, for property tax purposes, under which nonresidential commercial and industrial property undergoes a "change in ownership," to ensure that all real property is assessed at fair market value when that real property undergoes a change in ownership.

### ANALYSIS

#### Current Law

Under existing property tax law, real property is reassessed to its current fair market value whenever there is a "change in ownership." (*Article XIII A, Sec. 2; Revenue and Taxation Code Sections 60 - 69.5*)

Revenue and Taxation Code Section 60 defines a "change in ownership" to mean a transfer of present interest in real property including the beneficial use thereof the value of which is substantially equal to the value of the fee interest.

Revenue and Taxation Code Section 64 sets forth the change in ownership provisions related to the purchase or transfer of **ownership interests in legal entities** that own real property. Generally, when real property is owned by a legal entity, the purchase or transfer of ownership interests in that legal entity does not trigger a change in ownership of the property.

An exception to this general rule is when there is a "**change in control**" of the legal entity. Subdivision (c) of Section 64 generally provides that a "change in control" occurs when **one person** or legal entity **acquires more than 50 percent** of the ownership interests in the legal entity.

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### Proposed Law

Presently, this bill contains legislative findings and declarations and does not propose specific amendments to change any law. This bill would state that because of difficulties in identifying changes in ownership of certain nonresidential commercial and industrial properties, these properties often escape reassessment at full market value upon a change in ownership. Consequently it is the intent of the Legislature to enact a program to specify those circumstances under which nonresidential commercial and industrial property undergoes a change in ownership to ensure that all real property is assessed at fair market value when that real property undergoes a change in ownership.

It also notes that during the 1990s the share of real property taxes paid by nonresidential commercial and industrial property owners decreased, while the share of real property taxes paid by residential property owners (e.g., homeowners) increased.

Further it states that the lack of reassessment of nonresidential commercial and industrial property has caused certain negative consequences such as:

- Reducing property tax revenues available to build new infrastructure and provide vital services.
- Placing a greater property tax burden on newly constructed property.
- Encouraging local governments to seek sales-tax generating retail developments rather than job-creating developments such as manufacturing facilities.

### In General

**Property Tax System.** Proposition 13 approved by voters in 1978 substantially changed the property taxation system in California. In general, California's system of property taxation under Article XIII A of the State Constitution (Proposition 13) values property at its 1975 fair market value, with annual increases limited to the inflation rate, as measured by the California Consumer Price Index, or 2%, whichever is less, until the property changes ownership. At the time of the ownership change, the value of the property for property tax purposes is redetermined based on current market value.

**Change in Ownership.** While Proposition 13 provided that a “change in ownership” would trigger reassessment, the phrase was not defined. The Assembly Revenue and Taxation Committee appointed a special Task Force - a broad based 35-member panel that included legislative and board staff, county assessors, attorneys in the public and private sectors, and trade associations - to recommend the statutory implementation for Proposition 13 including its change in ownership provisions. The Task Force findings are published in California State Assembly Publication 723, **Report of the Task Force on Property Tax Administration**, January 22, 1979. A second report, **Implementation of Proposition 13, Volume 1, Property Tax Assessment**, prepared by the Assembly Revenue and Taxation Committee, California State Assembly Publication 748, October 29, 1979, provides additional information on how changes in ownership would be determined under Proposition 13.

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**Property Owned by Legal Entities.** One issue the Task Force faced was how to apply the change in ownership provisions of Proposition 13 to property owned by a legal entity. For instance, would a transfer of ownership interests in a legal entity that owns real property be considered a transfer of the real property interests and, thus, a change in ownership? The Task Force considered two alternatives, that were coined the “separate entity” theory and the “ultimate control” theory.

- **Separate Entity Theory.** The “separate identity” theory would respect the separate identity of the legal entity. Accordingly, for as long as the legal entity owned the property it would not be reassessed, even if all of the ownership interests in the legal entity had transferred.
- **Ultimate Control Theory.** The “ultimate control” theory would look through the legal entity to determine who held the ownership interests and, thus, who had “ultimate control” of the legal entity. Under this theory, real property owned by the legal entity would be reassessed only when a single holder of ownership interests gained control of the legal entity through the acquisition of a majority of those ownership interests.

The Task Force recommended that the separate entity theory be adopted for the following two reasons:

"(a) The administrative and enforcement problems of the ultimate control approach are monumental. How is the assessor to learn when ultimate control of a corporation or partnership has changed? Moreover, when the rules are spelled out (and the Task Force actually drafted ultimate control statutes) it became apparent that without trying to cheat many taxpayers as well as assessors would simply not know that a change in ownership occurred. The separate entity approach is vastly simpler for taxpayers and assessors to understand, apply and enforce. Transfers between individuals and entities, or among entities, will generally be recorded. Even if unrecorded the real property will have to be transferred (by unrecorded deed or contract of sale, for example). Taxpayers can justifiably be expected to understand that a transfer of real property is a change in ownership and must be reported to the assessor.

(b) The ripple effects of ignoring the general separate entity laws of the state could not be predicted. The ultimate control theory threatened unknown disruptions of business organizations and practices. The separate entity approach avoids that pitfall by adopting the existing structure of corporate, partnership, etc. laws and building upon them."

The change in ownership definitions related to ownership interests in legal entities initially placed in statute in 1979 was based on the “separate entity theory” as recommended by the Task Force. However, thereafter, subdivision (c) of Section 64 was added which provided that a change in ownership occurred whenever there was a change in control by a transfer (or transfers) of more than 50% of the total ownership interests to a single person or entity. According to **Implementation of Proposition 13**,

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Assembly Publication 748, subdivision (c), coined "the majority-takeover-of-corporate stock" provision was added "out of a concern that, given the lower turnover rate of corporate property, mergers or other transfer of majority controlling ownership should result in a reappraisal of the corporation's property -- an effort to maintain some parity with the increasing relative tax burden of residential property statewide, due to more rapid turnover of homes. It was also a trade-off for exempting certain transfers among 100% wholly-owned corporations<sup>1</sup>."

**Tax Burden** The Task Force was concerned that because commercial and industrial property changes ownership less frequently than residential property that a shift in tax burden to residential taxpayers could occur. The definitions originally proposed for legal entities (based on the separate entity theory) were chosen to mitigate administrative difficulties. Because of this concern, the Task Force proposed that the Legislature study the idea of a constitutional amendment to periodically appraise commercial and industrial property noting:

"[s]uch a constitutional change would also result in far greater simplicity in the treatment of legal entities. If commercial and industrial properties were to be periodically reappraised for reasons other than change in ownership, the difficult and controversial policy issues in choosing between the "ultimate control" approach or "separate entity" approach, outlined previously, would largely be avoided. The Task Force commends the principle of such a change to the Legislature for additional study."

**Homeowners' Percentage of Total Value.** The following information, which is annually prepared by the Board's Research and Statistics Section, lists the percentage of gross assessed value from properties receiving the homeowners' exemption compared to total assessed value.

1979-80	33.6%		1987-88	32.5%		1995-1996	37.6%
1980-81	36.3%		1988-89	32.6%		1996-1997	38.0%
1981-82	35.4%		1989-90	33.1%		1997-1998	37.9%
1982-83	34.5%		1990-91	32.8%		1998-1999	38.1%
1983-84	33.6%		1991-92	33.0%		1999-2000	38.2%
1984-85	32.9%		1992-93	34.2%		2000-2001	38.1%
1985-86	32.5%		1993-94	35.3%		2001-2002	38.0%
1986-87	32.4%		1994-95	36.7%			

### Background

Other bills that would have resulted in more frequent reassessment of property owned by legal entities include SB 1662 (Peace) in 2002, AB 1013 (Leonard) in 2001, AB

<sup>1</sup> Section 64(b) excludes transfers of ownership interests between affiliated corporations and Section 62(a)(2) excludes transfers which result in change in the method of holding title while the proportional ownership interests remain unchanged.

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2288 (Dutra) in 2000, and SB 82 (Kopp, et al) in 1991. Additionally, Proposition 167 in 1992, which addressed a number of tax related items, included a provision to modify the change in ownership definitions related to legal entities. Proposition 167 was not approved by voters (41.16% - 58.84%).

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the Pacific Institute for Community Organization (PICO) [www.PICOcalifornia.org](http://www.PICOcalifornia.org) and the California Tax Reform Association [www.caltaxreform.org](http://www.caltaxreform.org). Its purpose is to cause more frequent reassessment of nonresidential property to bring assessed values of impacted properties to current market value levels.
2. **What is a "split roll"?** Typically when the term "split roll" is used it means taxing certain types of property according to a different tax rate or standard of value. When the term "split roll" is used within the context of the existing property tax structure of Proposition 13 (Article XIII A of the California Constitution), it generally means changing the law to trigger more frequent "change in ownership" of property owned by businesses. A **true** "split roll" is not possible without a constitutional amendment.
  - **Tax Rate.** The tax rate (1%) applied to all property is embedded in the constitution. To apply a different tax rate to a particular class of property, such as "nonresidential commercial and industrial property" would require a constitutional amendment. (Article XIII A, Section 1)
  - **Standard of Value.** The constitution requires that all property (unless specifically provided for in the Constitution) be assessed at the same percentage of full cash value. To assess a specific class or type of property (i.e., residential, agricultural, commercial, industrial, or bare land) at a different standard of value would require a constitutional amendment. (Article XIII, Section 1)
3. **Change in Ownership.** While Proposition 13 provided that a "change in ownership" would trigger reassessment, the phrase was not defined. Statutory language defines the term "change in ownership" and details various transfers that are included or excluded from "change in ownership." Therefore, statutory amendments could, arguably, modify those definitions initially established.
4. **Currently, there are separate definitions of change in ownership for "transfers of interests in real property" and "transfers of ownership interests in legal entities" that own real property.** Under existing definitions of change in ownership, it is possible that the ownership interests in a legal entity may undergo a complete turnover in a series of transactions, but that the real property owned by the legal entity will not be reassessed. As a result, it is possible that real property owned by a legal entity since 1975 has never undergone a change in ownership

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and therefore been reassessed and may never be reassessed as long as the current definitions hold.

For example:

- Four individuals each own a 25% interest in a property. Each time an individual sells their interest to another person, a 25% reassessment of the property is triggered.
  - If the same property is owned by a legal entity in which the same four individuals each own a 25% interest in the legal entity, then if an individual sells their 25% interest in the legal entity to someone else, no reassessment will occur. This is true even if each of the four individuals sell their interests to other persons. Only if one person obtains control (more than 50%) will a change in ownership be triggered.
5. **Is the effect of the change in control provisions unintentional?** The Proposition 13 Task Force considered and debated the issue of transfers of interests in legal entities and current change in ownership definitions were consciously made. The question appears to be one of whether nearly 30 years later the definitions are still appropriate. The Task Force recognized the effect of these definitions over the long term noting "(t)he Task Force admits that some of its own recommendations, such as those regarding legal entities, while the best of a seemingly 'no-win' choice of options and adopted to mitigate administrative difficulties, may, in the long run, further exacerbate this [tax burden] shift to residential property because it will result in fewer potential commercial and industrial property transfers being recognized for reappraisal purposes." Consequently, the Task Force proposed that the Legislature later study a constitutional change to periodically reappraise commercial and industrial property.
6. **How might "change in ownership" be redefined?** Since 1991, there have been several unsuccessful attempts to redefine change in ownership for legal entities. Prior proposals generally redefined a change in ownership to occur when **cumulatively more than 50%** of the interests in the legal entity have transferred. Under such a redefinition:
- Real property owned by corporations whose stock is publicly traded could be frequently reassessed to current market values.
  - Real property owned by privately held corporations and other legal entities, would be less frequently reassessed, (fewer turnovers of ownership interests).
7. **Bills similar to this legislation are typically viewed in the context of commercial and industrial properties, but any real property owned by a legal entity (partnerships, limited liability corporations, corporations, etc.) would be subject to a revision of the definition.** This could include single family homes,

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multi-family properties such as duplexes and apartments, mobilehome parks, agricultural property, family farms<sup>2</sup>, and small businesses.

- **Legal entities own property used for residential purposes.** Legislation that redefines change in ownership as it relates to transfers of interests in legal entities would not be strictly limited to nonresidential property. For example, the following types of income producing "residential" property could be subject to more frequent reassessment:
    - single family homes owned by a legal entity
    - multi-family residential property (apartments, mobilehome parks, duplexes, etc.) owned by a legal entity.
    - owner occupied home owned by a legal entity
  - **Individuals own property used for commercial and industrial purposes.** Legislation that redefines change in ownership as it relates to transfers of interests in legal entities would not affect all property used for commercial and industrial purposes. Real property owned by an individual or individuals would not be impacted. For example, a building used for a commercial purpose that is owned by an individual would not be subject to a new definition, even if the owner of the business owns the real property on which the business is operated.
8. **Opponents of "split roll" legislation note that ultimately the higher property taxes paid by legal entities that own California real estate would result in:**
- higher cost of goods and services,
  - increase in rents for leased real property,
  - loss of business growth to other states and countries,
  - reduction of California competitiveness,
  - decrease in profits to owners and investors including retirees,
  - lower wages for employees of legal entities,
  - increase the size of government, and
  - increase government employee salaries
9. **Proponents of "split roll" legislation note that the current system is inequitable and that the tax burden is shifting to homeowners.** Individuals are not able to shield incremental transfers of interests from reassessment as are legal entities. With respect to shifting tax burdens, the share of assessed value from owner occupied homes ranges increased from 33.6% in 1979 to 38.0% in 2001. The percentage change from year to year varies and in some years has declined.

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<sup>2</sup> The parent-child change in ownership exclusion does not apply to transfers of ownership interests in legal entities. However, it is possible to use the parent-child exclusion by using a multi-step process: 1) Property is transferred from the legal entity to the parent as an individual. 2) The parent transfers the property to the child. 3) If desired, the property may be transferred from an individual into another legal entity. There is a one million dollar cap (assessed value not market value) on the value of property that may be transferred without reassessment under the parent-child change in ownership exclusion.

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10. **Property taxes paid by legal entities generally increase over time.** Businesses, unlike homeowners, also pay property taxes on their personal property holdings. Their personal property is assessed every year at its current market value. Additionally, as businesses grow and expand, any real property that a legal entity newly constructs or acquires is reassessed to current market value. Further, mergers and takeovers of corporations can result in reassessment triggers.
11. **Legal challenges of any new program might be made on the grounds that different change in ownership definitions violates the Equal Protection Clause.** The US Supreme Court has held in many cases that a differential system of taxation does not violate the Equal Protection Clause provided that the state legislature has a rational basis for such a system.
12. **The Administrative Workload.** Properties owned by legal entities are the most complex type of property to appraise and county assessors' offices would likely need to hire more real estate appraisers to handle the increase in real estate appraisal workload that any new program might create. Additional resources to (1) identify property owned by a legal entity, (2) determine which legal entities have had a change in ownership under any new definition, (3) appraise the properties owned by the legal entity, (4) defend or modify the appraisal pursuant to a formal or informal appeals, and (5) defend reassessments in court actions.
13. **Counties are not fully reimbursed for their administrative costs.** Counties perform the administrative duties of the property tax on behalf of all local governments and schools. But schools, which receive 52% of the property tax revenues, are not required to pay a pro-rata share of the administration costs, unlike other local governments. Counties receive only 19% of the property tax revenue. In recognition of this, the state has enacted the State-County Property Tax Administration Program which makes available \$60 million per year for counties.

The Legislative Analyst in a 1997 Report, **Improving the Incentives for Property Tax Administration**, notes:

The state has a significant interest in the property tax. Although the property tax has been considered a local tax, the state is in fact the largest beneficiary of property tax revenue growth. This is because increases in property tax revenues generally result in commensurate decreases in the required state contribution for education.

In spite of the considerable state interest in the property tax, the costs of property tax administration are borne almost entirely by local governments. Specifically, counties receive less than 20 percent of property taxes collected, yet they pay more than 70 percent of property tax administration costs. As a result, counties face a disincentive to investing in the property tax administration system.

[www.lao.ca.gov](http://www.lao.ca.gov)

14. **This bill could ultimately result in a significant overhaul of the property tax administration system as it relates to property owned by legal entities.** This is a fundamental policy issue, but with substantial challenges to create a program that

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is administratively feasible, cost effective, and minimizes burdens on taxpayers and counties. If this policy change is desired by the Legislature, then it may be beneficial to delay its implementation and once again establish a broad-based task force to create such program.

### **COST ESTIMATE**

The administrative costs to the Board depend on its role in tracking ownership interests in legal entities under any new program. No estimates of the costs can be determined without further clarification of the Board's role in any new program.

### **REVENUE ESTIMATE**

As legislative intent language, this bill has no revenue impact. An estimate of the revenue implications of the proposed concept will be deferred pending more specificity.

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